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In the Supreme Court of the United States

OCTOBER TERM, 1984

ARTHUR L. CHRISTOFFERSEN, ET UX., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Petitioner challenges the court of appeals' holding that he was the true owner, for federal tax purposes, of certain publicly-traded mutual fund shares underlying a "wrap-around annuity" that he had purchased, and hence that he was currently taxable on the income generated by those shares. The decision below is correct. As petitioner concedes, there is no conflict among the circuits on the question presented. There is no basis for further review.

1. In October 1981, petitioner Arthur Christoffersen[1] purchased a so-called "variable annuity contract" from Pacific Fidelity Life Insurance Company (Pacific) for $50,000 (Pet. App. 2a). The type of contract petitioner

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[1]Petitioner Theresa Christoffersen is Arthur's wife and is a party solely by virtue of having filed a joint federal income tax return with him for the tax year in question.

acquired is commonly known as a "wrap-around annuity."[2] The contract gave petitioner the option, in the year 2021, to purchase an annuity based on 1981 mortality tables; petitioner was charged an annuity option premium of $84.02 for this privilege (Pet. App. 2a & n.3).[3] He was also charged $3.79 for administrative expenses (*ibid.*). The balance of his $50,000 investment, or $49,912.19, was to be invested in any one of six publicly-traded mutual funds offered by Fidelity Management & Research Company. Petitioner was free to choose whichever fund he wanted. He directed that his $49,912.19 be invested in Fidelity Daily Income Trust, a money-market fund (*id.* at 2a).

The money-market mutual fund shares purchased at petitioner's direction were held in a separate sub-account maintained by Pacific; the shares were not chargeable with Pacific's other liabilities (Pet. App. 3a). As earnings accrued on the shares, petitioner could elect to have the income paid to him currently, or to have it reinvested in additional shares; he chose the latter option (*id.* at 2a). Petitioner bore the investment risk with respect to the shares and had the right (subject to a $10 surrender fee) to withdraw his investment, in whole or in part, on seven days' notice (*id.* at 3a). If petitioner lived until November 1, 2021, he would have the

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[2]The arrangement is so named because investment assets like stocks, bonds, or mutual fund shares are "wrapped" in an annuity contract in the hope that the investor may thereby escape current taxation on the investment income, a result that would of course be impossible if the investor were to purchase such assets directly. See Petrie, *Eroding the Tax Benefits of Wrap-Around Annuities: An Analysis of Revenue Ruling 81-225*, 34 U. Fla. L. Rev. 95 (1981).

[3]The annuity option premium (sometimes called the "mortality risk premium") was supposedly designed to compensate the insurance company for the risk that the taxpayer's life expectancy on November 1, 2021 -- should he survive until then -- would be longer than predicted by the 1981 mortality tables used to calculate the contract annuity rates. This premium was computed annually at a rate of 0.8% on the accumulated value of the taxpayer's "sub-account" (R. Doc. 24).

option at that time to use the accumulated value of his investment to purchase an annuity (*ibid.*). Otherwise, the accumulated value would be paid to him in cash (*ibid.*).

During the last three months of 1981, petitioner's "sub-account" earned income of $1,532 (Pet. App. 2a). Petitioner and his wife initially reported this $1,532 as interest income on their 1981 federal income tax return. Subsequently, however, they filed a claim for refund, contending that the $1,532 was not taxable.

Upon the Commissioner's denial of their claim, petitioners brought this refund suit in the United States District Court for the Northern District of Iowa. That court held that petitioner's contract with Pacific was "an annuity pursuant to 26 USC 801(g) qualifying for deferred taxation under 26 USC 72." It thus ruled that the $1,532 was not currently taxable to petitioner (Pet. App. 2c).

The court of appeals unanimously reversed (Pet. App. 1a-6a). It held that petitioner was the true owner for tax purposes of the money-market fund shares, since he had ready access to those assets at all times and had virtually complete control over their disposition (*id.* at 5a). And it held that petitioner was required to include the $1,532 in income for 1981, since he had the unrestricted right to receive that money and was thus in "constructive receipt" of the income for tax purposes (*ibid.*).

2. The decision below is correct. Petitioner challenges it on the theory that his investment is indistinguishable from any other "variable annuity contract," and hence that he should qualify for the tax deferral benefits generally accorded purchasers of that insurance product. But while petitioner's brief, like the contract he purchased, is redolent

of the language of insurance, he says little about the operative provisions of the Internal Revenue Code.[4] The pertinent definitional provision, Section 801(g)(1)(A), says that a life insurance annuity contract includes "a contract which provides for the payment of a variable annuity computed on the basis of * * * the investment experience *of the company issuing the contract*" (emphasis added). And Section 801(g)(5) speaks of "life insurance reserves" based on the underlying investment assets. The relevant Code provisions, in short, presuppose that a contract is a "variable annuity contract" for federal tax purposes only if the underlying assets are owned by the insurance company and not by the policyholder.

The court of appeals correctly held that the money-market mutual fund shares at issue here were "owned," for federal tax purposes, by petitioner and not by Pacific. It has long been established that taxation of income follows ownership and that, where title and beneficial ownership are split between two parties, beneficial ownership controls. *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358 (1939); *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930). Where (as here) some but not all of the rights associated with property have been transferred from one person to another, the determination of who "owns" the property for tax purposes requires a comparision of the rights retained with those surrendered. Where the former are more substantial than the latter, no shift in ownership is recognized. The Court made this clear in *Helvering* v. *Clifford*, 309 U.S. 331 (1940), where it held that the grantor of a trust had retained such substantial incidents of ownership with respect to the corpus that he remained its owner for federal tax purposes, notwithstanding that the trust was perfectly valid in other respects.

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[4]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

The court of appeals correctly held that petitioner had retained virtually all, and surrendered virtually none, of the incidents of ownership of the money-market mutual fund shares involved here. He decided what his money would be invested in; he bore the full investment risk; he had the right to receive the investment income currently; and he could redeem his investment in whole or in part whenever he wished. Indeed, petitioner had vis-a-vis the shares essentially the same rights as those possessed by any investor in a publicly-traded money-market mutual fund. To be sure, petitioner also had the right — which cost him $84.02 — to purchase an annuity in the year 2021, should he be alive then and choose to exercise his option. But the availability of that separable and discrete option obviously does not mean that the money-market fund shares were "owned" by the insurance company, or that the overall arrangement was a "variable annuity contract" for purposes of Section 801(g).

Since petitioner owned the shares, he was taxable in 1981 on any income the shares generated in 1981. It has long been established that an item of income is includable in the gross income of a cash-basis taxpayer for the year in which it is received, actually or constructively. *Corliss* v. *Bowers, supra*; Treas. Reg. § 1.451-2(a). Income is deemed "constructively received" when it is made available to the taxpayer on his demand without substantial restrictions. *Ibid.*

The court of appeals correctly held that petitioner constructively received the $1,532 in money-market fund income during 1981 because he had the unrestricted right to have that sum paid to him in cash. To be sure, petitioner elected not to take the cash, and chose instead to have it reinvested in additional shares. But a taxpayer cannot escape tax merely by turning his back on income while retaining and reinvesting it.

3. The decision below is the first appellate decision to address the federal tax consequences of "wrap-around annuities." Thus, as petitioner concedes (Pet. 14-15), there is no conflict among the circuits on the question presented.

Nor, contrary to petitioner's suggestion (Pet. 12), does the case warrant certiorari absent a conflict on the theory that the decision below "reverses 25 years of practice" in the taxation of insurance companies. The decision below does not address the tax consequences of "variable annuity contracts" under Code Sections 72 and 801(g). It holds simply that the money-market mutual fund shares involved here were owned by petitioner, not by the insurance company, and hence that petitioner, not the insurance company, is taxable on the income those shares generated. This principle is not novel.[5]

The result below, finally, works no unfairness upon petitioner. He purchased, through the medium of an insurance company, shares in a money-market mutual fund. Although his shares were held (as it were) in "street name," his rights with respect to those shares were functionally equivalent to those possessed by any money-market fund investor. Petitioner also purchased, for a modest sum, an option to buy an annuity 40 years down the road. That sum effectively represented a gamble that he, unlike other money-market fund investors, might thus defer tax on up to 40 years' worth

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[5]The IRS formally announced eight years ago that it would require the purchaser of a "wrap-around" annuity to include currently in income the earnings from the "wrapped" assets where, under the terms of the contract, the purchaser rather than the insurance company possessed the more substantial incidents of ownership. Rev. Rul. 77-85, 1977-1 C.B. 12. In Rev. Rul. 81-225, 1981-2 C.B. 12, the Commissioner reaffirmed that ruling, holding that an insurance company will be considered to own "wrapped" mutual fund shares only where the investments are controlled by the insurance company and the shares are not offered for sale directly to the general public.

of investment income. He did not wager a large amount. He got more or less what he paid for.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

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